IN THE

Supreme Court of the United States

OCTOBER TERM 1964

No. 237

COMMISSIONER OF INTERNAL REVENUE,
Petitioner

v.

ROBERT LEE MERRITT, ET UX., ET AL.

On Writ of Certiorari To the United States Court of Appeals for the Fourth Circuit

BRIEF FOR RESPONDENTS

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BRIEF FOR RESPONDENTS

Preliminary Statement

This case is consolidated with No. 134 and this brief is in reply to the brief for the Commissioner (respondent in No. 134 and petitioner in this case, No. 237) and the brief for the petitioner filed by Paragon Jewel Coal Company, Inc., (petitioner in No. 134). Any relevant matters contained in the *Amicus Curiae* brief filed by Jewell Ridge Coal Corporation in support of petitioner in No. 134 will be discussed herein.[1]

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[1] The following abbreviations will be used throughout this brief: "Comm'r. Br." refers to the Brief for the Commissioner. "Paragon

QUESTION PRESENTED

The issue in this consolidated case is whether the coal mine operators operating in various partnerships during the years 1954, 1955 and 1956 are entitled to an allocable portion of the percentage depletion allowance based on amounts received for mining coal under agreements with the sub-lessee of the mineral rights or whether the sub-lessee is entitled to deduct percentage depletion on its gross income from the property, undiminished by amounts paid to the coal mine operators for coal mined and delivered to the sub-lessee. The Tax Court decided that the sub-lessee was entitled to the entire percentage depletion deduction. The Court of Appeals for the Fourth Circuit reversed and determined that the sub-lessee is required to share the depletion deduction with the coal mine operators.

Statement of Facts

C. A. Clyborne acquired by lease and purchase certain coal bearing lands located in Buchanan County, Virginia. In 1951 Clyborne created Paragon Jewel Coal Company, Inc. (hereinafter "Paragon"), the corporate stock of which is held almost exclusively by Clyborne and his wife and he has always controlled this corporation. After Paragon was formed, Clyborne assigned leases held in his name to his corporation for an overriding tonnage royalty. This royalty was deducted by Paragon as an operating expense and reported by Clyborne as long-term capital gain.[2] (R. 191, 196)

Br." refers to the Brief for the Petitioner in No. 134. "Jewell Ridge Br." refers to the Amicus Curiae brief filed by Jewell Ridge Coal Corporation in support of petitioner in No. 134.

[2] The returns of Clyborne for the years 1955, 1956 and 1957 show that he received coal royalties from Paragon in the aggregate amount of $471,425.93, which were deducted by that corporation as operating expenses and reported by Clyborne as long-term capital gain. (Ex. 1-A, 2-B, 3-C)

Under the assignments from Clyborne, Paragon assumed the obligations to pay minimum royalties,[3] tonnage royalties and land taxes, all of which were deductible by that corporation as business expenses or taxes. Paragon made substantial investments for processing, shipping and marketing coal all of which were deducted as a business expense, depreciation or amortization. In fact, all expenditures of Paragon with reference to its coal operations were so deducted for tax purposes. (R. 84, 211)

In 1951 Paragon had acquired substantial acreage of coal bearing lands from Clyborne. It had erected an expensive processing plant and was committed to the payment of certain minimum royalties. Production of the coal was essential but most of Clyborne's experience had been as a sales agent, wholesaler or processer and Paragon was intended to be a processing rather than a producing coal company. Also, Paragon did not have any excess funds to invest in the coal producing business—it was in debt approximately $300,000, was six months behind in the payment of its bills and its financial outlook was dark. Since coal mining is very hazardous, Clyborne did not want to expose his personal funds to the dangers inherent in the coal producing business. (R. 34-36, 45, 253)

The coal was to be produced by the drift mining method, which is prevalent in the Appalachia area of Virginia, West Virginia and Kentucky. Drift mining is an underground mining operation, in which a horizontal coal seam is reached by clearing away a part of the mountainside with a bulldozer. Two openings are made into the coal seam. One is an entry and the other is an air course which is used to ventilate the mine. Coal is removed as the drift mine is driven into the mountain following the seam of coal. Generally, the coal seam ranges from

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[3] Paragon prepaid some minimum royalties, which were all recouped as a result of the coal production of the mine operators. (R. 84)

thirty inches down to two inches, and in some places it pinches out entirely. The height of the mine is approximately thirty inches. Such shallow seams are known as "low coal", and are not capable of being mined by automatic or highly mechanized equipment. The roof of the mine is supported by leaving a certain amount of coal in place known as pillars, and also erecting wooden supports every eighteen inches known as timbers. When the mine is driven to its full extent, which may be more than a mile as in some instances in this case, the pillars of coal are removed as the miners retreat. The coal is obtained from the seam either by cutting it on the bottom with a machine which yields a lump coal, or by a "solid-shot" (explosion) method which yields a fine powder. Drift mining is recognized in the industry as a most difficult and economically marginal operation.[4] (R. 43-45, 67, 101, 102, 106, 109, 116, 117, 132, 136, 150, 253).

Rather than mine the coal, Paragon elected to rely on others exclusively for production and entered into verbal agreements with coal mine operators who mined the coal. In many instances in Buchanan County, Virginia, leases to people who mine coal are oral—not in writing at all. It is a common practice in that area to transfer coal mining interests and rights by verbal agreement—such rights are transferred on the mountainside—not in law offices and the agreement is concluded by a handshake—rather than a signature and seal. (R. 37-39, 46)

In addition to equipment necessary for processing and shipping coal, Paragon installed a road running around the mountain close to the outcrop line of the seam of coal over which the coal could be hauled from the mines to

[4] Most of the coal in the Appalachia area is produced by large companies with expensive automatic and highly mechanized equipment. Drift mining is about the only means by which a small operator of moderate means can develope a mining organization and engage in the coal mining business in that area.

Paragon's processing plant. At the plant Paragon cleaned, sized and sold the coal. Beginning in 1951 Paragon entered into oral leases or agreements with a number of mine operators, including respondents in No. 237, all of which were similar in terms. Under the agreement an operator would be allocated a specific surface area under which it could mine the coal. The operator assumed Paragon's obligation to open, develop and preserve the mineral property and agreed to mine all mineable and marketable coal within that area and deliver it to Paragon at the operator's expense. Paragon agreed to handle and pay for all marketable coal produced by the operators. Paragon agreed to pay a fixed price per ton of marketable coal at the tipple, but it was understood that the price per ton would, and in fact it did, vary with the market price of coal. (R. 49, 54-56, 64, 90, 106, 114, 119, 136, 147, 180, 186, 253, 254)

All expenses of opening, developing and operating the mines were to be borne by the several operators. Such expenditures including building a road from Paragon's road to the mine entry, clearing the area at the mine site, making the installations and preparations at the mine site such as, building a tipple, laying track to the mine, obtaining machinery and equipment, installing an electric power plant and fans and the construction of several buildings. The operators were responsible for the safety and proper development of the mine and were required to obtain mining permits and develop and operate their mines in accordance with state and federal mining laws and regulations. Also, they were to pay the taxes on their equipment, obtain liability insurance, maintain proper ventilation and roof support and overcome any adverse mining conditions such as water, faulty roof and rolls, which occur when the seam of coal squeezes out. The several operators agreed to use and pay for the services of a mining engineer designated by Paragon. (R. 103, 104, 111-118, 123, 162, 167, 183, 214)

After an operator entered upon the property it would take from six weeks to two months of preparatory work before he could mine coal. Even then the operation is unprofitable. A drift mine must be developed by driving a main entry, air courses, cross sections and rooms to create enough ventilated working areas so that a sufficient daily tonnage can be produced to make the mine profitable. It took the operators from six months to a year and often longer to complete the development of their mines and reach the production stage when the mines became a profitable operation, and in some mines, they extracted all of the coal without ever attaining sufficient daily tonnage to make the mine profitable. (R. 115, 116, 123, 137, 154, 215)

Paragon agreed to and did handle all marketable coal which the several operators produced. Paragon has an exclusive contract with John McCall Company to handle all coal processed by Paragon. Coal delivered by the operators and others is delivered to Paragon's tipple, where it is processed, dumped into railroad cars and sold to John McCall Company f.o.b. at the tipple. Paragon's only contact with the coal is the brief period of time it is going through its processing plant. (R. 107, 254)

Although Paragon agreed to handle all of the operators' coal it agreed to pay only for marketable coal. If the operators delivered outcrop coal or other coal of inferior quality, Paragon could refuse to take it because it agreed to handle only coal which was marketable. Also, Paragon paid less for solid shot coal than for machine cut coal because solid shot coal is less desirable from a marketing standpoint. Finally, Paragon had no obligation to pay the operators for any adverse mining conditions. In drift mining it is not unusual to encounter water in the mine. When this occurs the mine operator must set pumps and draw the water to the outside of the mine. While this is being done, production ceases and sometimes it takes days

or even weeks to clear a watered mine. (R. 54, 106, 116, 117, 214)

The mine operators frequently encountered "rolls", which is the term used to describe the situation where the seam of coal which is generally 24 to 30 inches thick diminishes to a few inches. Thus, the mine operator has no coal to mine but must continue to drive through the sandstone. This is very expensive because of the hardness of the sandstone, which must be broken by explosives and then hauled to the outside of the mine. It was not unusual for the several mine operators to be confronted with rolls which took weeks to go through. The mine operators received nothing for going through rolls, even though it was more difficult and costly than the mining of coal. (R. 116, 117, 123, 162, 168)

The areas of coal originally leased to some of the operators involved in this litigation were enlarged by mutual agreement—the designated areas were never decreased. (R. 78, 79, 83)

The agreements were silent as to who was entitled to depletion and they contained no termination date and nothing was said between the parties on this subject. Paragon knew that: the operators would engage in large expenditures of time and money in preparing their respective sites for mining, would have to operate for a period of development before their mines would become profitable, they would encounter adverse mining conditions which would be costly to overcome, and the operators could recoup therefrom only if they were able to continue mining. The operators were encouraged by Paragon to make the investments essential to the development and preservation of the mineral property. They made these investments in time and money and assumed most of Paragon's obligation under its leases because they understood that their operations could not be terminated until they had mined their respective areas to exhaustion and

that they would receive a fair price based on the conditions of the coal market for the coal which they produced. (R. 54, 65, 106, 115, 130, 137, 145-147, 156, 170, 173, 178, 185, 186, 215)

Respondents and the other mine operators involved in these proceedings have mined coal under their respective agreements from the time they were made, during the period from 1952 to 1957, until the present time. During this period, the agreements have been adhered to by both parties in accordance with the terms as described above. (R. 130, 131, 141, 143, 212, 213)

Prior to April 1957 when the case of *Stilwell* v. *United States*, 250 F.2d 736 (4 Cir. 1957) was decided, Paragon was aware of the operators' claim that they had a right to mine their respective areas to exhaustion and that the price which they were to be paid for coal produced could be changed only on the basis of a change in the market price of coal. This claim of the operators was sustained by the court below in the *Stilwell* case. Thereafter, Paragon asked the respondents and Stilwells to sign written agreements which they refused to do because such agreements did not correctly reflect the terms of oral agreements under which they were operating. Paragon took no further action, and from that time until the present has accepted benefits under such agreements without any effort to negotiate the differences or to have them adjudicated. Since Paragon has accepted the coal produced and has made changes in the price per ton only when there were significant changes in the market price of coal, the operators were not aggrieved and have had no occasion to negotiate or adjudicate the alleged differences in the terms of their agreements with Paragon.[5] (R. 56, 154)

[5] A tax case is not the best forum to decide disputed terms of an oral agreement. The simple, direct and most inexpensive way to determine whether Paragon had the right to terminate at will

SUMMARY OF ARGUMENT

Under the guiding principles of this Court as expressed most recently in *Parsons* v. *Smith*, 359 U. S. 215, and Treasury Department Regulations and Rulings, the coal mine operators are entitled to share with Paragon the depletion allowance for the following reasons:

1. The substantial investments made by the operators in the development and operation of their coal mines establishes their capital investment in the coal in place. Said capital investments resulted from the fact that Paragon was unwilling or unable to make such investments in its own behalf and the coal mine operators relieved Paragon of its investment obligations in this respect thereby satisfying the criteria that the taxpayer claiming a share of the depletion allowance must possess a capital investment in the mineral in place.

2. The oral leases or contracts were silent on the matter of termination, but because of the substantial investments made by the operators in the coal in place, the operators' rights could not be terminated

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would be for it to bring an action of ejectment in Buchanan County where the agreement was made. Or, if, as the Commissioner contends, Paragon could fix the price per ton at will, all it had to do was decrease the price without a corresponding decrease in the market price of coal, then the operators would be in a position to take action. Paragon did neither—it preferred to take the benefits of the agreement as understood by the operators. Paragon is not without resourceful counsel. The terms of the agreements here in question could have been decided long ago and for a fraction of the expense it has spent in connection with this tax litigation if Paragon had so desired. Possibly, Paragon concluded that its chances of success in a local court were not good and it would be better to pursue the costly route of tax litigation. The operators had no similar opportunity to judicially test their right to mine the designated areas to exhaustion. The operators were in possession of the mines and, as far as they were concerned, Paragon was living up to its bargain with them in every respect.

at the will of Paragon without cause, particularly where the parties intended the coal operators to mine as long as coal was obtainable and could be profitably sold.

3. The return of the coal mine operators' investments was dependent upon the extraction of the mineral and they shared with Paragon an interest in the proceeds from the sale of coal because they were paid only for marketable coal and the price per ton was subject to change in accordance with changes in the market price of coal.

4. The position of the Commissioner, namely, that the operators were being paid for services and that Paragon was legally free to set the price paid to the operators at any level it chose, is speculative in nature, not supported by the record and is contrary to the determination of the court below and to the published position of the Treasury Department in G. C. M. 22730, 1941-1 C.B. 214.

5. The position taken by Paragon that the right to depletion is dependent upon "ownership of the mineral property" is contrary to all decided cases, the Internal Revenue Code and the Regulations thereunder. Paragon's contention that the application of the several factors listed in *Parsons* v. *Smith*, supra, indicates an absence of an economic interest being vested in the operators is in conflict with the facts of this case.

ARGUMENT

It is not difficult to state the general principles which govern the depletion allowance—the problem arises in applying these principles "according to the peculiar conditions in each case" as required by the statute. Respond-

ents' agree with this Court's statement of the controlling principles in *Parsons* v. *Smith*, 359 U.S. 215. Respondents further agree with the Commissioner's statements of the applicable general principles of depletion law; namely, that the right to an allocable portion of the depletion allowance depends on the ownership of an economic interest, that there may be more than one depletable interest in the same deposit, that the purpose of the deduction for depletion is in recognition of the fact that the mineral deposits are wasting assets and is intended as compensation to the owner for the part used in production, and that the deduction is available only to the owner of a capital interest in the mineral deposit. Respondents also agree that the legal form of such a capital interest is unimportant so long as this ownership constitutes a capital asset, a right with regard to the mineral in place.

Respondents submit that the operators had a capital investment in the coal in place and were the owners of an economic interest as the court below found. The Fourth Circuit determined that the claim of the coal mine operators was valid under the rationale of *Parsons* v. *Smith*, supra. Thus, it was guided by the legal principles set forth in that case.

I The Coal Mine Operators Made A Capital Investment In The Coal In Place and Could Look Only To The Extraction and Sale of The Coal Deposit For A Return Of Their Capital

1. *Nature and Extent of The Investment Made By The Coal Mine Operators*

Each operator made substantial investments in their respective mines during the development stage. The record makes it clear that a designated area was given to an operator by Paragon, after Paragon did some preliminary external facing work (for which the operators paid Paragon) and constructed a road to the general area of the

mine entry. Thereafter, the development of the underground mine was the responsibility of the operator. Unlike a strip mine contractor, who could begin full production immediately upon removal of the overburden with one employee and a mechanical shovel mining hundreds of tons of coal in one day, the drift mine operator could not reach the production stage[6] for several months and sometimes years.

It was necessary for the operator to mine underground to a sufficient depth to expose enough coal so that the full compliment of his labor force had individual working areas from which they could mine coal. This required considerable time because the working area was never more than approximately 30 inches high, the only light available was that which the miners could carry on their persons and equipment, the coal had to be loaded by hand and only two or three miners could work in an area at a time. Moreover, if a drift mine is to be practical, the operator must engage, in addition to his own labors,[7] a large number of employees, because each miner can load but a few tons of coal per day. In addition, the first coal mined was not of marketable quality (outcrop coal) and had to be discarded. It normally required six to eight weeks before any marketable coal was reached by the operator and several months before the mine reached the production stage. (R 115, 116, 123, 137, 154, 215)

The coal mine operators, and not Paragon, were obligated under state and federal law, to provide for the

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[6] The production stage is defined as that time when the major portion of the mineral production is obtained from workings other than those opened for the purpose of development, or when the principal activity of the mine becomes the production of developed ore rather than the development of additional area for mining, Treasury Reg. § 1.616 - 2(b)

[7] All of the operators involved in these proceedings are working miners, who devote their full time to their operations and are in their mines every day. In addition to the investment in money they make a substantial investment in time and effort.

safety of the mine, including the development of air courses as well as the main entry. Air courses are necessary for ventilation of the working areas and without them, no drift mine could be operated. The burden of the development of working areas and the establishment and maintenance of air courses was the obligation of the operators. No like capital investment is made by a strip miner. It is quite obvious that these investments enhanced the value of the coal that lay beyond and to the side of the main entry, cross sections, room and air courses, for unless this development was completed such coal could not be mined. These undisputed facts refute the contention that the operators did not have a capital investment in the coal in place.

The operators' investments in the coal in place did not terminate with the end of the development stage. Further capital investments were made during later stages of the mining operation. For example, the mine operator had a continued obligation to maintain roof support of the mine. As the operation progressed, all loose coal had to be removed from the roof and timbers placed on 18 inch centers. Also, pillars of solid coal must be left to help support the roof. Most of the mines in these proceedings extend over a mile underground and in the Stilwell operation, the mine at the time of the hearing (November 1961) was over 8,000 feet long. These pillars are not removed until the operators reach the end of their designated areas. At that time, the operation retreats, the coal forming the pillars is extracted and the mountain settles down closing the area which contained the seam of coal. Proper roof maintenance, the setting of timbers and the facing and preparation of pillars is a capital investment, since without such an investment the coal lying beyond is worthless because it cannot be mined if the roof falls. Each timber and pillar enhances the value of the coal remaining in the ground. Indeed, the pillars are in and of themselves a valuable source of coal which can be mined most eco-

nomically, but they cannot be mined until they have served their purpose of roof support.

Moreover, the progress of the mining operation does not always result from the extraction of coal. The particular seam of coal here involved, is unpredictable and most difficult to mine. (R. 44, 67). The entries must be driven from time to time through areas where nothing but unmarketable rock is removed. This is due to the irregular nature of the seam of coal, when the coal squeezes out into what is called a "roll". When a roll is encountered, the operator has no choice but to continue mining operations through the rock in the hope that mineable coal will be reached before he goes broke, because the coal beyond the roll cannot be reached unless the roll is overcome. Since cutting machines cannot be used successfully on the rock the procedure is to loosen it by explosives and remove it from the mine. Even though this operation is more costly than mining coal the operators receive nothing for the mining of rock. Many are the drift mine operators, who have broken their financial as well as their physical back on a roll. All of the operators involved here encountered rolls (R. 67, 101, 117, 123)—in one instance an operator mined for six weeks and removed nothing but rock. (R. 123) To consider the operators' excavation of rock anything but a capital investment in the remaining coal is to ignore reality.

By contrast, in a strip mining operation there is no entry, air course, pillars or timbering. If a strip miner encounters a pinched seam or a roll, he merely moves his equipment further along the surface and begins removing the overburden and the coal where the coal vein resumes. Some distinctions with respect to the capital expenditures of a deep mine and a strip mine were recognized by the Tax Court in *National Lead Co.*, 23 T. C. 988 (1955) rev'd on other grounds 230 F.2d 161 (2 Cir. 1956), aff'd C.A. 352 U. S. 313. In that case, the Tax Court

observed that it was easy to understand that a shaft dug from the surface to a mineral deposit lying under the surface, which shaft is to be used to gain access to the underlying ore and to bring the mined ore to the surface is a capital expenditure made to develop the ore body. The Tax Court added that it was not readily apparent to it that any comparable expenditure was involved in the cost of stripping overburden and cutting benches in an open (strip) mine. In this case the Tax Court's conclusion that the operators' investments were similar to the investments of the contractors in *Parsons* v. *Smith*, supra, (R. 222) is most difficult to understand. Possibly it was premised on its obviously erroneous finding that the operators "did not assume any of Paragon's obligations under its leases . . . ." (R. 214) As the court below noted "Paragon was under obligation to mine the property. These operators were performing Paragon's obligations under its leases . . ." (R. 255). Or possibly it was based on an erroneous understanding of what constitutes an investment or more properly a capital investment.

A capital investment is an expenditure of money or other consideration to acquire something of permanent value for use in carrying on a trade or business—or the consideration paid for a capital asset. Obviously, the removal of outcrop coal, development of working areas, preparation of pillars, timbering, excavation of the air courses and mining through rolls all involved expeditures by the operator that were useful until all the coal was exhausted.[8] After they were made the operators had a capital asset, that is a developed and operating mine, which is useful in their trade or business until the mineral deposit is exhausted.

The development and long term expenditures of the operators are capital in nature, even though they are

[8] The Stilwells, for example, have been mining in the same mine for thirteen years and the Merritts for over ten.

deductible under Section 616 of the 1954 Code, which provides that expenditures for the development of mines are deductible as an expense in determining income. This provision was part of the Revenue Act of 1951. Prior to its enactment the operators would have been required to carry their development costs in a capital account recoverable through the depletion allowance.[9] Under present law the deduction of development costs is allowable in addition to the depletion allowance. Accordingly, the characterization of such expenditures as capital in nature is in no wise affected by their deductibility.

Under the present statute it makes no difference, therefore, whether these expenditures are made during the production or development stage of the operation. Prior to 1951, however, the difference was important since if the expenditure was made during the development stage, the expense had to be put into a capital account and recovered through the depletion allowance. The cases dealing with tax years prior to 1951, therefore, will show what type of expense had to be capitalized and hence what type of expense represented a capital investment in the mineral deposit.[10] See for example *National Lead Co.*, supra, *Clear Fork Coal Co.* v. *Comm'r*, 229 F.2d 638 (6 Cir. 1956) where the court held that development consists of creating enough working places for the use of all available machinery of the mine; *Commissioner* v. *H. E. Harman Coal Corp.*, 200 F.2d 415 (4 Cir. 1952) where the court held that where machinery was purchased not solely because of the recession of working faces but in the interest of economy and efficiency such expenditures were capital investments; *Alsted Coal Co.* v. *Yoke*, 200 F.2d 766 (4

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[9] Regulation 94 Art. 23(m-15)(a) All expenditures in excess of net receipts from the mineral sold shall be charged to capital account recoverable through depletion while the mine is in the development stage.

[10] Reg. 118, § 39.23 m - 15(a)(1), Reg. 111, § 29.23 m - 15(a), Reg. 103, § 19.23 m - 15(a).

Cir. 1952) where expenditures by a second coal operator to remove water and debris and to retimber a dormant mine were held to be development costs and chargeable to capital to be recovered through depletion; *United States Gypsum Co.* v. *U. S.* 52 AFTR 1819 (D.C.N.D. Ill. 1957) aff'd 253 F.2d 738 (7 Cir. 1958) where the court held that expenditures for an additional mine entrance, extension of the main haulage track and extension of an air shaft are development expenditures, and *Repplier Coal Co.* v. *Commissioner*, 140 F.2d 554 (3 Cir. 1944) cert. denied 323 U.S. 736, where cost of constructing a tunnel even after the development stage was past was found to be of a capital nature. For a comparison of oil well development costs and mine development costs, see *Burnet* v. *Petroleum Exploration*, 61 F.2d 273, 276 (4 Cir. 1932), aff'd 288 U. S. 467.

It can be seen from the above that the operators have made substantial capital investments in the coal by their expenditures. The investments involved were not the investments of Paragon, even though some were made to carry out Paragon's obligations under its leases. It matters not that Paragon has not parted with its capital interest other than passing on to the operators the investment risks and obligations that attend development of the mines. A capital interest in the operators can be created by their own investment. In G.C.M. 22730 1941-1 C.B. 214,216 The Commissioner concluded that:

> ". . . [T]he view that a lessor, or sublessor or assignor, parts with no capital interest, though the lessee, or sublessee or assignee acquires a capital interest upon the execution or assignment of a lease, presents no logical difficulties, as the lessee interest, though it may have great potential value, ordinarily becomes valuable only upon investment by the lessee in exploitation or by reason of discovery. . . .
>
> "[at p. 221] The lessee or assignee, like the lessor or assignor who retained a share interest in pro-

> duction . . . but passed on to the lessee the investment obligations and risks that attend development for a share in production, has parted with no capital interest but has merely in turn given another a right to share in production in consideration of an investment made by such other person. . . ."

Since Paragon was financially unprepared and unwilling to assume the investment risks of the development of the mines but passed them on to the operators, neither Paragon, nor the Commissioner is warranted in asserting that the operators did not obtain a capital interest merely because Paragon did not intend to part with its capital interest. The operators' capital investment obviously took place as shown above; their capital interest in the coal was thereby created. The Tax Court's conclusion that the operators paid nothing for the coal and had no legal title to the coal is therefore refuted. Legal title is not determinative and the investments made by the operators in the coal in place clearly vindicates the Fourth Circuit's reversal of the Tax Court.

A mineral in place has often been characterized as a "reservoir of capital investments", G.C.M. 22730, supra. One who furnishes money or is pledged to the development of the property is regarded as making an investment in the mineral in place. Surely, both Paragon and the operators had a share in this reservoir since they pooled their resources, funds and energies leading toward the extraction of the mineral. Neither could recover, process and sell the mineral without the other and the depletion allowance is an attempt to compensate each party for the exhaustion of the mineral. When the area is mined to exhaustion, both Paragon and the operators will be required to look for new areas to mine. In the case of the operators, they will be able to move some of their equipment but most of their investment will lie useless in the vacant mine. If they are to continue in the same business, the operators will be required to reinvest the funds

they recover through the depletion allowance in another mine in the same manner that Paragon will move its tipple and find new sub-leases in another sector. The interests of both Paragon and the operators are being depleted as the coal is mined—both therefore have an economic interest in that coal until it is exhausted.

2. *The Operators' Capital Investments Were Made Pursuant to Agreements Which Gave Them A Continuing Right To Mine Their Areas To Exhaustion.*

In *Parsons* v. *Smith*, supra, the strip miners insisted that they did not wish to be bound by a contract "which would take a long time since if an opportunity opened up [the strip miners] wanted to go back to road building." The strip miners there involved were primarily road builders who were using their road building equipment to temporarily strip mine coal, and they could not be damaged by a short term notice of termination: In a ten day period the strip miners could load all of the coal from which they had removed the overburden. Their investment was in road building equipment and in the relatively fixed cost of removing a known quantity of overburden.

Unlike the taxpayers in *Parsons* v. *Smith*, supra, the operators here would be seriously prejudiced by a termination of their operations. Their investments were long term investments. Their present costs of the construction of an air course for ventilation was made with the understanding that it would be used for all the coal to be mined. Their expense of removing rock during a pinch or roll was made with the thought in mind that there would be removable coal on the other side that they could mine. Their efforts in making pillars, timbering and in draining the mine were made solely with the view of reaching all of the coal in their designated areas.

The fact that the coal mine operators would be required to make long range investments would have been obvious

to anyone familiar with drift mining operations and was implicitly recognized at the time the agreements were made. It was known specifically by Clyborne, the controlling stockholder and directing head of Paragon, because the investments which his corporation was obligating the operators to make, were the precise investments which he personally refused to make and which his corporation was unprepared and unwilling to make. (R. 34-36, 253) Indeed it was the policy of Paragon to encourage its operators to make such investments.

Paragon remained silent on the matter of termination at the time the agreements were negotiated for good reasons. If it had reserved a right to terminate, the agreements would not have been made. Respondent Watson stated the position of the operators when he testified "Well, I knew this, we had a certain boundary of coal which was given to us and told we could mine it out. If we had not had that assurance, we certainly would never have invested the sums of money that we did in the property." (R. 173) And, Meadows, not a respondent, testified that Paragon made it clear that Meadows could mine all the coal in his boundary and that if he "had the least bit of idea they could run me off overnight I wouldn't have invested my money there . . .". (R. 183)

The Tax Court correctly found that the right of termination was not specifically discussed at the time the agreements were made. Then, even though respondents and Paragon were before the Tax Court as adverse, but equal parties—both as petitioners having an equal burden of proof—the Tax Court concluded that because the agreements did not contain a specific statement that they were *not* terminable at will of Paragon or because they did not contain a specific statement that the operator had the right or obligation to mine to exhaustion that as a matter of law the operators did not have such rights. The Tax Court did so in the face of its own finding as to the intent of the parties that: (R. 215)

> "It was anticipated by both parties that a contractor [coal mine operator] would continue mining in the location assigned to him as long as the coal could be mined and sold at a profit and as long as the contractor employed proper mining methods and produced coal meeting Paragon's specifications."

The court below properly concluded that this finding as to the intent of the parties negated the Tax Court's conclusions as to the legal rights of the parties under the contract. In reaching its conclusion the Tax Court also ignored the relative position of the contracting parties, the purposes to be accompilshed by the contracts, the nature of the consideration involved on each side and the time and extent of performance by the parties. When these are considered, it is clear that Paragon did not, as a matter of law, reserve a right of termination at will and without cause. The court below stated the principle well when it said: (R. 254)

> "It would be inequitable indeed to hold that Paragon might remain silent on this point until the operators had invested their time and money and then take the benefit of the operator's efforts at will and without cause. [citations omitted]"

In a mineral lease where there are no provisions to the contrary, the lessee has the right to terminate at his will, but a corresponding right to terminate is not vested with the lessor, see Summers, *Oil & Gas* Vol. 2, 2 Ed. § 235, discussed, infra, beginning at page 44, and Donley, *The Law of Coal, Oil and Gas In W. Va. & Va.*, (1951), § 57 p. 70. The reasons for this rule of law are obvious; the long term investments made by the lessee in development of the property should inure to his benefit and to subject that right to termination without cause by the lessor would work an unwarranted hardship. Conversely, no such right is given the lessor for if the lessee terminates, the lessee's investments which have enhanced the value of the mineral property accrue to the benefit of the lessor.

It was the mutual intent and purpose of Paragon and the operators that pursuant to their oral agreements the operators would immediately enter upon the premises, prepare and develop their respective mines and produce coal. This consideration was of value to Paragon, since it relieved Paragon of undertakings which it was obligated to perform under its leases and enhanced the value of such leases. Obviously, the operators could cease operations only if they were willing to lose the investments which they had made in the mineral property. But, even if the operators could cease operations, the agreements are not lacking in mutuality. *Phillips Petroleum Co.* v. *Buster*, 241 F.2d 178 (10 Cir. 1957), certiorari denied 355 U. S. 816 involved an oral agreement which was challenged as void for indefiniteness, uncertainty and lack of mutuality. In sustaining the agreement the Tenth Circuit stated at p. 183:

> "* * * Harmonizing in full measure with the general principle of law obtaining elsewhere, it is the rule in Oklahoma that the destruction of contracts or agreements for vagueness and uncertainty is disfavored; and that if a contract or agreement is sufficiently definite and certain in its totality that the intention of the contracting parties can be ascertained with reasonable certainty, it is not void for indefiniteness and uncertainty even though it fails to enter into all of the details respecting the subject matter, especially where there has been partial performance.
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> * * * *
>
> "Another ground of attack upon the judgments is that the oral agreements lacked mutuality of obligation. The channel of the argument is that there was no agreement in respect to the term or duration of the agreements; that there was no agreement respecting the extent or length of time plaintiffs would irrigate their lands; that there was no agreement concerning the volume of gas plaintiffs would take; that there was no agreement that plaintiffs would not

change to some other type of fuel; that they could take or not take gas at their own whim or caprice; and that in the event they should cease to take gas, Phillips would be without recourse or remedy. * * * The oral agreements for the furnishing of gas for the operation of the water wells having been entered into with the mutual intent and purpose that plaintiffs would act in reliance thereon, plaintiffs having acted in such reliance by making substantial expenditures in the drilling or the completing of the drilling of the wells and in preparing the land for irrigation, and plaintiffs being in reasonably certain danger of suffering irreparable injuries for which there would be no adequate remedy at law if the furnishing of gas were discontinued, equity finds support in the law of Oklahoma for intervening and restraining the threatened discontinuance of the furnishing of gas. * * *"

The Tax Court never found as a fact that Paragon had a right of termination; it merely concluded without citing any authority or reasons that "It seems unlikely that the parties would have contemplated granting the contractor [operator] the nonterminable right to mine specific areas to exhaustion without also obligating him to so mine it." (R. 223) Since such an agreement is not lacking in mutuality and Paragon could suffer no detriment, but would benefit from the investment of the operator in the leased property if the operator ceased mining the "unlikeliness" of the Tax Court's conclusion is clearly refuted.

Accordingly, the conclusion of law by the Fourth Circuit as to termination should be sustained. If the Tax Court's finding of fact is correct that nothing was said by either party as to termination, then by implication of law, the *right* of the operators to mine to exhaustion should be that found by the Fourth Circuit. If the issue is to be decided on past events, then it can be shown that none of the operators here involved or Paragon ever terminated a contract at will. If the issue is to be decided

by what the usual mineral lease contains it must be held that a right to terminate at will is not usually given a lessor. If the issue is to be decided on the finding of the Tax Court as to the intent of the parties, then the operators again must be sustained for the Tax Court specifically found that the parties "anticipated . . . that a contractor [operator] would continue mining in the location assigned to him as long as the coal could be mined and sold at a profit . . ." If the issue of termination is to be decided upon what provision the reasonably prudent man familiar with drift mining would include in an agreement, the conclusion that Paragon had no right to terminate at will without cause must again be reached.

Respondents do not understand the Commissioner to contend otherwise. Apparently, it is the Commissioner's position that the operators could be forced out by Paragon exercising an alleged "power" to lower prices.

3. *The Operators Could Look Only To The Extraction and Sale of The Coal For A Return of Their Investments*

In *Parsons v. Smith*, supra, the strip miners were to be paid a fixed sum for each ton mined and delivered which was agreed to be in "full compensation for the full performance of all work and for the furnishing of all [labor] and equipment required for the work". On the basis of such an agreement, this Court determined that the strip miners "agreed to look only to the landowners for all sums to become due them under their contracts" and that such an agreement was "a personal covenant and did not grant or purport to grant an interest in the coal in place." In the case at bar the intent, understanding and rights of the parties was quite different.

Paragon was not interested in paying for services, work or the furnishing of equipment required for the work. Paragon was seeking someone to assume its obligations

under its leases to develop and operate drift mines and extract all mineable and marketable coal. Moreover, Paragon made it clear that it was willing to accept and pay *only* for marketable coal. It would not accept outcrop coal because it was not marketable (R. 54), and Paragon would not pay as much for "solid shot" coal as it would for "machine cut" coal because "solid shot" coal will not bring as much on the market (R. 106). Also, Paragon deducted from the amounts due the operators the weight of any rock and other amounts that were cleaned from the coal at its processing plant. (R. 49) Paragon understood fully that the seam of coal was unpredictable and irregular, that it was a very thin seam "which in some places pinches out entirely". (R. 44) It was fully aware that there would be times when the operators would be working their entire labor force excavating rock and not producing any coal at all. Under the agreements the operators were to receive nothing for such efforts and expenditures.

In *Parsons* v. *Smith*, supra, the strip mine operators were guaranteed a fixed price per ton. The mine operators here had no such guarantee—their income (return of their investment) was dependent upon the market price of coal. This was the understanding and it was adhered to by the parties. Whenever there was a significant increase in the market price of coal, the operators expected and received an increase in the price for their coal. And conversely when there was a decrease in the market, they expected and accepted a decrease. Like any business man who is compelled to take less for a marketable commodity, the operators grumbled and complained, but they made no issue of the decreases because they knew that the coal market was depressed. In *Parsons* v. *Smith*, supra, the changes in price were made *only* on the basis of and to reflect increases in labor costs and materials required by the strip miners—the market price of the coal never en-

tered into the agreement in any way. Here, the market price was the controlling factor.

The Tax Court correctly found that it was understood between Paragon and the operators that the price per ton to be paid the operators would vary from time to time and that it did so vary depending upon the market price for the coal over extended periods. (R. 214) It also attributed the variation "to some extent on labor costs" when there was no evidence to support such a conclusion. Some of the increases occurred at a time when the United Mine Workers negotiated increases in their labor contracts. But Paragon was not a union operation and neither were the operators here involved. The particular wage agreements negotiated by the U. M. W. caused a general increase in the market price of coal and this was the basis for Paragon's changing the price paid the operators. Actually, Paragon was not concerned with the labor costs of the operators and knew nothing about such costs.

Stilwell, (R. 114) Lee Merritt, (R. 136) G. W. Merritt, (R. 147) Watson (R. 169, 17[illegible]) and Meadows (R. 180) testified that under their respective agreements the price per ton would increase or decrease according to changes in the coal market. This testimony was neither contradicted nor challenged by Paragon—indeed it was corroborated by Clyborne. He stated that the "price continued until there was some change in the market substantially, then we would raise or lower it." (R. 56)

Woods testified that the prices which Paragon received for the various sizes of coal on the commercial market changed daily. The operators were producing raw coal or what is referred to as "run of mine" coal. The price for "run of mine" coal does not vary daily with the prices for the various grades of processed coal on the commercial market. Admittedly, the price received by the operators per ton did not vary on a day-to-day basis with the price received on the commercial market by Paragon

for the various grades of coal which it processed and sold. This was not the agreement. It is clear, however, that whenever there was a substantial or significant change in the market price of coal, either up or down, the operators' price per ton was changed accordingly. This was the agreement—the price per ton was not fixed by the terms of the agreement—but was dependent upon the state of the market.

The Tax Court and Paragon place great weight on the fact that changes in price were not made retroactively and, thus, when an operator delivered coal to Paragon he knew the "fixed" price per ton he would receive before he delivered the coal. (R. 222) True, but the price was not fixed and the operator did not know what price he would receive for coal next week, next month or next year. When the agreements were made, the operators intended to recover their investments from the unmined coal over the period it would take to mine their respective areas to exhaustion. Yet because the operators knew on a given day what they would receive for the 100 or so tons mined on that day, it is contended that they were being paid a fixed sum and were thus relying on the personal covenant of Paragon without regard to the market price of coal.

Paragon was the payor, but it refused to give the operators its personal covenant. Under their agreements the operators were required to look beyond Paragon to the market price of coal for the return of their investments. Actually, the price to be paid the operators for the coal they agreed to mine was unknown both to Paragon and the operators at the time the agreements were made. By mutual agreement it was made dependent on factors beyond the control of either party. In this respect this case is distinguishable from *Parsons* v. *Smith*, supra.

II. Analysis of the Commissioner's Brief

1. *Statement of Facts.*

The Commissioner's statement of facts is most incomplete and is not an adequate basis for a determination of this case. In addition, many of the matters stated as fact are inaccurate.

The Commissioner contends that the operators "did not assume any of Paragon's obligations under its leases". (Comm'r Br. 4, footnote 2)

The most burdensome obligation of Paragon under its leases was the obligation to develop the mineral property and remove the coal in the most effectual, workmanlike and proper manner and in conformity with the laws of the State of Virginia and the United States regulating the working of mines, drifts, gangways and other necessary and appropriate openings for airways, and ventilating passageways and to drive the regular size of gangways and airways through such portions of the seams of coal as may prove faulty, or may not yield mineable and merchantable coal and to leave pillars and suppports necessary for the support of all entries and gangways and to mine and recover all coal which by the exercise of care and proper mining methods is practical to recover. (Ex. 16-P, Page 4, Paragraphs VII and VIII) Paragon did not have the funds to fulfill these obligations and Clyborne did not want to expose his personal funds to the dangers inherent in meeting these obligations. (R. 35, 45, 55) These are the obligations of Paragon, which the operators assumed. Indeed, they more than assumed Paragon's obligations in this respect. In some of its leases Paragon was obligated to remove only 85% of the mineable and merchantable coal; the operators agreed to extract *all* mineable and merchantable coal. (R. 211, 254, 255).

The Commissioner refers repeatedly to the agreement of the operators to deliver all coal which they mined to

Paragon; (Comm'r. Br. 5, 7) but he omits the other part of the bargain. Paragon agreed to accept and pay for all marketable coal produced by the operators. (R. 54) It was a mutual obligation in this respect, not a one-sided agreement as the Commissioner supposes. In consideration for the operators delivering all marketable coal produced to Paragon, it agreed to accept all such coal and pay an agreed price which was subject to change on the basis of market conditions.

Next, it is contended that Paragon set and changed at will the price per ton paid the operators. This statement is refuted by the discussion at pages 24 to 27 of this brief. In addition, Clyborne in testimony given in September 1955 (in a case which did not involve the issue of depletion) when asked about the agreements here involved answered as follows: (Ex. 73, p. 13)

> "That is right, the price varies from time to time according to market conditions."

The Commissioner's contention is also refuted by the conduct of Paragon. The first change was a negotiated increase which occurred in February 1952. (R. 118, 119) Thereafter Paragon initiated the price changes, but every change occurred at the time when there was a corresponding change in the market price of bituminous coal. Although Paragon had a burden of proof equal to that of respondents, it did not introduce any evidence with reference to the price it received from its exclusive sales agent, John McCall Company for coal sold during this period. It sold its coal in competition with other wholesalers and processors and in the absence of any evidence from Paragon's records (which could have been produced easily by Paragon) it is fair to assume that the changes in Paragon's prices were in accord with changes in the general market for bituminous coal. The record contains a schedule of prices paid the operators (R. 230, Ex. 74) and the Average Price Index of Bituminous Coal for the peri-

od here involved as disclosed by the United States Department of Labor. (R. 248-252, Ex. 98) Comparison of these documents show that each increase or decrease in the price per ton paid by Paragon occurred at the time of a corresponding increase or decrease in the market price as shown by the index of the United States Department of Labor. In the Appendix (p 49) of this brief respondents have prepared a graph based on a comparison of Exhibits 74 and 98. This graph demonstrates the relationship between the price per ton paid the operators and the changes in the market price of bituminous coal.

The Commissioner's claim that the operators' right to payment did not depend upon the existence of sales proceeds is unrealistic. Paragon was engaged in the business of processing and selling coal. The operators would deliver the coal to Paragon's tipple and it would process it, dump it in railroad cars and it was sold to John McCall Company f.o.b. tipple and John McCall Company takes it from there. (R. 107)

It is stated that the operators "were free to quit at any time" (Comm'r Br. 6) If the operators quit, they would not only lose their investment in the mineral property, but would also leave to Paragon's benefit the enhancement of the coal deposit resulting from their expenditures and efforts. G. W. Merritt stated that the matter clearly when he testified, "After I got my investment in there, I couldn't quit" (R. 156) and Watson stated that if they had quit "that development, effort and work and expense would have been lost." (R. 173)

Other erroneous factual statements of the Commissioner have already been discussed and answered in this brief.

2. *Argument of the Commissioner*

As previously indicated, respondent does not dispute the legal principles stated by the Commissioner, but it is submitted that his application of these principles to this

case is unrealistic and unrelated to the facts. It is contended that the operators are required to deliver the coal at whatever price Paragon chose and if they refused to mine at the offered price, Paragon could substitute other operators to do the mining. This statement is pure speculation and is contradicted by the record.

It is true that the operators agreed to deliver all coal to Paragon. But, it is equally true that Paragon agreed to accept and pay for all marketable coal produced by the operators. Thus, both parties had an obligation to each other. The price per ton was set by agreement, but was subject to change on the basis of changes in the market price of coal. The Commissioner contends that Paragon was legally free to set the price at whatever level it chose and could thus force the operators to cease their operations and substitute another operator in their mines. Under the facts of this case neither the law, nor the operators is as helpless as the Commissioner supposes.

Let us assume that at a time when the operators were receiving $4.25 per ton, there was a significant increase in the price for coal, and Paragon decided to reduce the price to $4.00, $3.50 or $3.00 per ton and the operators refused to deliver coal to Paragon at such a price. Obviously, Paragon could not substitute another operator because the present operators had legal possession of the property. Paragon could bring an action of ejectment and the issue before the court would be whether the parties had abided by the terms of the agreement. If Paragon elected not to bring an action of ejectment, but persisted in its refusal to pay the proper price for the coal, the operators could declare a breach of the agreement and sell the coal to one of the other coal processors in the area. From the proceeds of such sales they could withhold the proper price per ton and remit the balance to Paragon. If Paragon wanted to stop such action, it would be compelled to bring a legal suit in which the issue would

be whether the parties had abided by the terms of the agreement.

In any legal action the position of the operators would not be difficult to sustain. Coal mining is the only industry of any consequence in Buchanan County, Virginia and people there are as knowledgeable as to changes in coal prices, as little-leaguers are to the batting average of Mickey Mantle. (R. 91, 143) The operators could compel Paragon to show the price it was receiving for coal at all relevant times and from such data a court could readily determine whether the reduction in price to the operators was in accordance with or contrary to any change in the market price of coal. Moreover, there are standards by which the rights of the operators could be determined. Paragon was purchasing coal from operators on mineral properties on which it did not hold the lease. On such purchases, it had to pay the market price, otherwise the operator would take his coal to another processor. The price picture of such purchases could be used as a standard to determine whether any change which Paragon initiated was proper under its agreement with its operators. Also, there are other processing companies, some accepting coal from the same seam and in the same area as Paragon. The prices they pay for coal mined by their operators and for off lease coal is common knowledge in Buchanan County. The tipple price being paid by processors in that area is as well known as any other fact of economic life. Such price changes are infrequent, but when they occur everyone knows about it.

To argue, as Commissioner does, that the operators were at the complete mercy of Paragon as to price is not supportable on the record. This depletion controversy with Paragon has extended over the last 8 or 9 years. If Paragon could have controlled this situation by virtue of a legally free right to set the tipple price at any level it chose, and if the operators refused to deliver coal, trans-

fer their mines to another, it would have done so long ago. (See Footnote 5, supra)

The bargaining power of the operators arose, not from any right that they had to quit, as the Commissioner maintains, but from the right which they had to stay in possession of their mines and compel Paragon to abide by the terms of the agreement.

The improbability of the position he adopts is best illustrated by his comments in footnote 4 (Comm'r. Br. p. 19). Therein, the Commissioner admits that Paragon could not very well exercise the alleged power to lower prices since at a minimum Paragon was required to offer the same tipple price to all the operators. In effect, the Commissioner is saying that Paragon only had the power to terminate none or all of its contracts at the same time; a most improbable and unrealistic proposition, in view of the fact that during its taxable year ending September 30, 1957 on coal produced by its operators, Paragon, after deducting royalties paid to Clyborne of $154,552.07, reported net income of $650,981.94, claimed depletion in the amount of $325,490.97 and paid tax on $325,490.97. (Ex. 62-BK, Statement of Net Income From Coal Mining and Depletion Schedule)

The court below reached the proper conclusion when it stated "it was understood that the price would, and in fact it did, vary with the market" (R. 254) and that the "operators had a continuing right to produce coal and to be paid therefor at a price which was closely related to the market price." (R. 255)

The other unrealistic and unsupportable position of the Commissioner is that the operators' rights in the mineral deposit were no greater or different than that of the office personnel of Paragon, who likewise may be able to demand higher salaries when business is good. The comparative positions of Paragon's office personnel and the coal mine

operators are not even remotely parallel. An office employee does not make an investment in the coal in place, works at the discretion or will of Paragon, is paid on a time basis, is guaranteed the stipulated amount for his services if he works the required time and works directly under the supervision of Paragon. The office employee offers only his services and Paragon pays him for services and continues employing him as long as such services are satisfactory.

The agreement between Paragon and the operators is quite different. The operators were obligated to make investments in a mineral deposit, Paragon does not tell them when to work or how to work, its interest is only in receiving the coal they produce. The operators are responsible to the governmental authorities for the proper conduct of their mining operations; their only connection with Paragon in this respect is that the operator employ and *pay* a mining engineer designated by Paragon to assure that they stay within their respective areas, so that their mines do not run together and cause ventilation or safety problems. The operators are not paid for services, have no guaranteed compensation or minimum payment, but are paid solely on the basis of the mineral produced and their income is dependent upon the value of that mineral on the market. The operators employ a large number of laborers and are obliged to meet payrolls and other expenditures over extended periods of time when they are receiving no income whatsoever.

No useful purpose would be served by enumerating the remaining distinctions, nor to comment on the Commissioner's analogy between the operators and an employee in the automobile industry. The facts stated above and elsewhere in this brief demonstrate conclusively that the obligations, rights, and interest of the operators in this case are quite different from those of an employee. Paragon could have offered the operators an employment con-

tract, but it did not want any of the expense, burden and responsibility of development and production of the drift mines.

III Analysis of Brief for Paragon

Respondents will not answer in detail Paragon's labored discussion of the law of depletion. If, as Paragon sometimes states, the depletion allowance is available only to a taxpayer who owns a capital investment or capital interest in the mineral in place, respondents agree and there is no dispute. But, if as Paragon sometimes states, the depletion allowance is available only to the owner of the mineral in place, respondents submit that Paragon's position is contrary to decisions of this Court and to language which has remained in Treasury Department Regulations since 1939 without material change.

If ownership of the mineral in place were essential to the depletion allowance, Treasury Department Regulations would so state, but they provide to the contrary. Section 1.611-1 (b)(1) of the Regulations under the 1954 Code provides that "Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber." If ownership of the mineral were to control it would be simple to so provide by eliminating the words "an economic interest in."

The Regulations adopted as its definition of an "economic interest" the following statement of this Court in *Palmer v. Bender*, 287 U. S. 551, 557:

> "The language of the statute is broad enough to provide, *at least, for every case* in which the taxpayer has acquired, by investment, *any interest* in the oil in place, and secures, by *any form of legal relationship*, income derived from the extraction of the oil, to which he must look for a return of his capital." [Emphasis supplied]

The presence of such terms as "at least", "for every case," "any interest" and "any form of legal relationship" in this classic definition forecloses any concept that the depletion allowance is available only to the owner of the mineral deposit. Indeed the holding in *Palmer* v. *Bender*, supra, was that depletion did not depend upon any special form of legal interest in the mineral deposits. Recent cases of this Court reiterate this view. *Commissioner* v. *Southwest Exploration Co.*, 350 U. S. 308; *Parsons* v. *Smith*, supra. In the latter case this Court declared at page 221, footnote 7, that the principles of *Palmer* v. *Bender*, supra, had been consistently recognized and applied. And near the conclusion of its opinion in *Parsons* this Court stated at p. 226:

> " 'The controlling fact is that [petitioners] had no interest in the [coal] in place' * * * [P]etitioners simply entered into contracts, terminable without cause on short notice * * * to provide the equipment and do the work required to strip mine and deliver coal from those lands, as independent contractors, for fixed unit prices."

Thus, under the regulations and decisions of this Court the essential requirement is not ownership of the mineral in place, but ownership of an economic interest in the coal in place.

Paragon attempts to give an erroneous impression of this Court's holding in *Helvering* v. *Bankline Oil Co.*, 303 U.S. 362. At pages 27 and 29 of Paragon's brief, Paragon claims that the taxpayer in *Bankline* had a contract to "extract gasoline" and that "a mere economic advantage" arose "out of a contract to extract that mineral." Chief Justice Hughes clearly set forth the position of this Court on the matter at p. 367:

> "It is plain that, apart from its contracts with producers, respondent had no interest in the producing wells or in the wet gas in place . . . . It was not en-

gaged in production. Under its contracts with producers, respondent was entitled to delivery of the gas produced at the wells, and to extract gasoline therefrom, and was bound to pay to the producers the stipulated amounts."

The Government's position on *Bankline* is contrary to the position urged by Paragon. In General Counsel Memorandum 22730, 1941-1 C.B. 214, which contains a discussion of *Helvering v. Bankline Oil Company*, supra, and *Helvering v. Mountain Producers Corp.*, 303 U.S. 376, with reference to the question of producing and processing the General Counsel states at page 220 that in *Bankline*:

> ". . . the taxpayer's capital investment was in *equipment facilitating delivery of the gas produced rather than in equipment for production of gas*, and that its function was not production of gas, but the processing of gas. The Mountain Producers case, supra, is distinguishable in that the refining company purchaser *therein was a producer* and was required to make the *capital investment necessary to production* that gave the producer an economic interest in the oil and gas in place." [Emphasis supplied]

The position taken in G.C.M. 22730, supra, underscores the importance of the capital investments made by the operators in the instant case. They were required to make "the capital investment necessary to production". Thereby they obtained an economic interest as in *Helvering v. Mountain Producers Corp.*, supra, and not a mere economic advantage. Paragon uses the word "extract" completely out of context—"extraction of gasoline" from produced gas is not the same as the extraction of ore or gas from a mineral or gas deposit. In the sense that Paragon would employ the word "extraction", the word "processing" is more appropriate.

Beginning at page 58 Paragon asserts that certain legislation supports its position. Its first contention is that

when Congress enacted the words "each separate interest owned by the taxpayer in each mineral deposit" in Sec. 614 (a) I.R.C. 1954, it meant that a taxpayer must own the mineral deposit before it is entitled to depletion. As indicated immediately above this is not the view of the Commissioner as expressed by regulations under the 1954 Code; nor is it the view of this Court which has repeatedly held that the law of depletion requires an economic rather than a legal interest in the mineral deposit. Section 614 deals primarily with unitization and not the allocation of the depletable interests.

Next, Paragon insists that under Section 631(c) of the 1954 Code, the depletion deduction in the case of coal leases belongs indivisibly to the lessee. Section 631(c) provides that in certain situations an owner who *disposes* of coal under any form or type of contract by virtue of which he retains an economic interest in such coal shall not be entitled to the allowance for percentage depletion, but is entitled to capital gains treatment. In the case of certain owners Congress substituted one form of tax treatment for another. Congress did not, however, change the principle long recognized by the Courts and still a part of our tax law that a number of taxpayers may hold an economic interest in a mineral deposit and share in the depletion allowance. Sections 1.611-1(c)(1) and (2) of the Regulations refer to "several owners of economic interests" and "in the case of a lease or *other contract* providing for the sharing of economic interest in a mineral deposit, or standing timber." [Emphasis supplied]

In Section 631(c), Congress defined the word "owner" to mean "any person who owns an economic interest in the coal in place including a sublessor." Yet, Paragon insists repeatedly the ownership for purposes of depletion means ownership of the mineral deposit in place.

The Treasury Department has not by regulation, nor has the Government in litigation, placed such an interpretation on these sections—even though the statute has been in existence for twelve years. Paragon does not cite any Committee Reports, Treasury Department Rulings or decided cases in support of its interpretation.

Beginning at page 70 of its brief, Paragon discusses the several factors enumerated in *Parsons* v. *Smith*, supra, indicative of the absence of an economic interest, and Paragon attempts to apply those factors to the instant case. Its assertions are refuted by an examination of the facts:

1. Paragon states that the operators investments were in their equipment, all of which was movable—not in the coal in place. This assertion is fully answered at pages 11 to 19 of this brief.

2. Paragon contends that the operators' investments in equipment were recoverable through depreciation—not depletion. The operators had some equipment on which they claimed depreciation, but the major portion of their investment was in the coal in place as indicated under 1 above. It should be noted that every dollar that Paragon has expended in this enterprise has been deducted for tax purposes as a business expense or through depreciation or authorization. (R. 84) Thus, Paragon has no investment whatsoever that it is not recovering in some manner other than through depletion.

3. It is asserted that the contracts were completely terminable without cause on short notice. Such assertion is answered at pages 19 to 24 of this brief and comment here will be limited to the points raised by Paragon.

First, Paragon contends that "Paragon could not give an absolute nonterminable right to mine to exhaustion in view of the landowners reserved rights under the Paragon lease to terminate in the event of noncompliance with

the terms of the lease. Most leases are terminable in case of default and if Paragon could terminate only at the penalty of losing its entire interest in the mineral deposit it could hardly be regarded as an agreement in which Paragon has an absolute right to cancel at any time without cause or condition.

In *Commissioner* v. *Southwest Exploration Company*, supra, Southwest held the right to drill for oil, but it was provided that if Southwest should default in the performance or observance of any of the terms, covenants and stipulations, its right to drill and produce oil could be cancelled. (p. 315) Thus, by default Southwest could terminate the rights of the upland owners, but this was not deemed significant and the upland owners were allowed depletion. As noted in that case the "tax law deals in economic realities, not legal abstractions".

Next Paragon argues that this case should be decided on the basis of a clause in an inconsistent sentence, quoted out of context, from two exhibits. Exhibits 86 and 87 (R. 231-246) were offered by Paragon and received by the Tax Court for impeachment purposes only. (R. 161) Now, after the trial is concluded, Paragon, having disavowed any such purpose at the trial, insists that these exhibits are independently probative as admissions. These exhibits were prepared by C. J. Stull. G. W. Merritt testified that Earl Bowman brought the documents to Grundy one night, asked Merritt to sign them—which he did—and that Merritt took them downstairs and had them notarized. Merritt never met Stull and did not know where he got his information. Merritt denied reading the documents and stated that he never made such statements to anyone and they were not correct. (R. 156-161) Merritt did not swear that he read these documents; nor did he sign on the page containing the verification. A notary public signed the verification, but whether she read it or asked Merritt about it is not known. The informa-

tion which Stull used was obtained from Bowman from some undisclosed source. Bowman is a former employee of R. C. Persinger & Company, accountants for the respondents. At the time of trial Bowman was working for the accountant who does the accounting work for Paragon. (Tax Court Transcript 1227-30)

If Exhibits 86 and 87 are to be used to impeach Merritt or if they are independently probative as admissions the entire document should be examined.

Both exhibits contain in the Statement of Facts section the following:

1. "The partnership was obliged to extract *all* mineable coal in the area allocated to it". [Emphasis supplied]

The above statement is hardly consistent with a right to terminate.

2. "The question of the right to terminate *never arose* between the partnership and Paragon." [Emphasis supplied]

If the question never arose, how could the contract have specified the right of termination by either party. Later in the Argument section of each protest it is stated:

"The contract specified the right of termination by either party at any time, but the question never arose between the partnership and Paragon."

As indicated, if the question *never arose*, how could the agreement specify the right of termination. The sentence is inherently inconsistence. If Merritt's testimony is to be impeached it should be done with clear and consistent statements and not by a document which in the main corroborates his testimony, but which contains one inconsistent sentence.

Each document contains the statement that the agreement was similar to the agreement considered by the

court below in *Stilwell* v. *United States*, 250 F.2d 736 (4 Cir. 1957). As Paragon concedes the court below determined in the *Stilwell* case that the agreement was not terminable. (Paragon Br. 74) A fair examination of the provisions, including the inconsistent sentence relied on by Paragon, leads to the conclusions they were the same as the Stilwells, that is, not terminable as the court below decided.

Having insisted that Merritt changed his testimony, Paragon seeks to explain it by arguing that terminability did not assume any importance in decisional law until the decision in *United States* v. *Stallard*, 273 F.2d 847 (4 Cir. 1959). According to Paragon, Merritt was not concerned about terminability until sometime after December 1959 when he became aware of the headnote in the *Stallard* case and decided to swear up to it at the trial of this case. To make this theory of Merritt's shortcomings plausible, Paragon must ignore, as it does, the headnote and controlling finding of the court below in *Stilwell* v. *United States*, supra, decided December 27, 1957, approximately five months before Exhibits 86 and 87 were signed. The headnote in Stilwell mentions in an important way the fact that the contract was not terminable at will. In addition, the court below in discussing the crucial factors in Stilwell states "A most important factor is the terminability of the taxpayers' rights."

It is open to question whether Merritt read the *Stallard* headnote or not. There can be no doubt, however, that Merritt had an avid interest in the opinion in the *Stilwell* case for the understandable reason that his agreement was also with Paragon and contained the identical terms and conditions. Also, his mines were adjacent to Stilwell's and he was in almost daily contact with the Stilwell brothers. If Merritt is a self-serving falsifier as Paragon contends, the occasion for him to serve himself by false statements was in May 1958 when he hoped to set-

tle his case by showing it was the same as *Stilwell*. That he signed documents at that time with an inconsistent statement as to termination indicates an attitude of reliance on those whom he had engaged to handle his tax matters. Such an attitude is not uncommon in Buchanan County, Virginia—particularly among coal mine operators who are not educated in matters of law, accounting or tax procedure. It might be added that it is not uncommon for taxpayers to sign documents without reading them. Unless Merritt read page 8 of these Exhibits he would not have known that he should have read them before signing.

Paragon makes no comment on the testimony of its General Manager Woods. Although he did not make the agreements here involved, Woods testified that if an operator mined properly and produced coal and complied with state and federal regulations he had the *right* to stay and mine the coal. (R. 106)

Paragon contends that many operators quit at will. None of the operators involved in the present litigation ever terminated his agreement, although some did purchase mines, mining rights and equipment from other operators thereby working a novation and not a termination. (Exhibit 84) Other operators did quit, but the reasons for their doing so are not a matter of record. Many drift mine operators go broke and are compelled by financial circumstances to abandon their operations and leave their investments, but whether this is a termination at will is open to question. A contract terminable at will is one in which there is an absolute right to cancel at any time without cause or condition. It is clear that the operators could terminate only on the condition that they leave their investments in their mines.

The position of Paragon that as "a matter of state law it is plain that if a contract is at the will of one party, it is at the will of both" is not well taken. *Cowan*

v. *Radford Iron Co.*, 83 Va. 547, 3 S. E. 120 (1887) is a judicial mutation and the point for which it is cited by Paragon was dictum, which has been thoroughly disapproved in later cases in other states and has not been followed in Virginia. Summers, *Oil and Gas*, 2 ed Vol. 2 Section 235 "Leases as a Tenancy at Will" presents a full discussion of the erroneous doctrine in *Cowan* and its subsequent rejection by the Courts. Summers concludes that following the lead of the Ohio court in *Brown* v. *Fowler*, 65 Ohio St. 507, 63 N. E. 76 (1902) the federal and state courts, except for some early decisions in Oklahoma and Texas, had rejected the erroneous doctrine that an oil and gas lease created a tenancy at will.[11]

The other cases cited by Paragon are also inapposite. The rule which it states applies only to an agreement which is wholly executory and consists of mutual promises each the consideration for the other. It does not apply where consideration has been given for a mineral lease, which gives the lessee an interest in the right to explore and develope the mineral property and the mineral produced, even though he has the privilege of surrendering the lease at any time. *Lindlay* v. *Raydire*, 239 F.928 (D.C.E.D. Ky 1917) affirmed 249 F. 675 (6 Cir. 1918). The *Lindlay* case discusses *Cowan* v. *Radford*, *supra*, and notes that it is of no value upon such a question even in the jurisdiction of Virginia.

What Paragon ignores is the partial and continuing performance of the operators. Whether either party could have terminated before the operators began performing under their agreements or the rights of Paragon in the event of abandonment by an operator is not the question, but whether Paragon, after having encouraged and obligated the operators to act to their detriment, could take

[11] Under Virginia law, the principles applicable to oil wells are also applicable to mines, *Graham* v. *Smith*, 196 S.E. 600 (S.C. App. Va. 1938)

the benefits of the operators' investments at will and without cause.

4. Paragon argues that as lessee it did not agree to surrender and did not actually surrender any capital interest in the coal in place. This contention is answered fully elsewhere in this brief. It is noted here that Paragon agreed to and did surrender to the operators an interest in the coal in place, its right to mine the coal, or to determine who would mine it. Before entering into agreements with the operators Paragon did not own the coal in place, but held the right to mine the coal and reduce it to possession and ownership. After these agreements it held the right to acquire and sell it only. The operators held the right to mine the coal, reduce it to possession and be paid in accordance with the market.

5. Paragon insists that the coal belonged entirely to it at all times. It has been herein shown that ownership of the mineral is not essential to the depletion allowance. The mineral belonged to the landowners until it was extracted and reduced to possession by the operators—then Paragon could acquire it if it so elected, under its agreement with the operators to handle all marketable coal. If it was marketable, Paragon accepted the coal and immediately after delivery sold it to John McCall Coal Company. If the operators produced coal which was not marketable Paragon would not take it. Before and after the coal was mined it did not belong entirely to either Paragon or the operators. The latter had certain rights in the coal at all times.

6 and 7. Paragon's contentions that the contractors were to be paid a fixed sum for each ton and that payment was dependent upon the personal covenant of Paragon without regard to the market price of coal have already been answered, supra, at pages 24 to 27.

8. The "rigid control of the actual mining operation" argument of Paragon is not supported by the record. It is contended that the engineer directed the operators in detail. The engineer was selected by Paragon, but was paid by the operators, whom he served with reference to all engineering work inside the mines. (R. 60). The engineer inspected the operations generally when called by the operators and rendered his services when needed at their request. (R. 116) On the few occasions when disputes arose it was the operators and not the engineer who resolved the differences. Actually, the function of the engineer was to assure that the various mines stayed within their areas. Aside from this rather tenuous argument, Paragon cites no other facts which would indicate any control over the mining operation. Paragon fails to mention the vast number and variety of independent actions taken by the operators over which Paragon had no control. It was interested only in receiving the production from the operators' mines and indicated little interest and had no control over the way such mines were operated. It was the operators and not Paragon who were directly responsible to the federal and state coal mine authorities for the safe and proper conduct of their mining operations. In short, all decisions regarding the mining of coal were made by the operators and not Paragon. (R. 53, 54, 118, 129, 254)

IV Comments of Amicus Curiae Brief of Jewell Ridge Coal Corporation

In an *amicus curiae* brief filed in No. 134 Jewell Ridge Coal Corporation seeks to influence the deliberation of this Court by suggesting that if the present case is affirmed the Commissioner's petition in No. 262 should be granted to consider additional arguments allegedly available in that case. Such argument according to Jewell Ridge is that: (Jewell Ridge Br. 2, 3)

"* * * [T]here was an express understanding between Jewell Ridge and its contract mine operators that Jewell Ridge could, as it did, maintain complete unilateral control over the amount of coal which its contract mine operators were from time to time permitted to mine."

This statement is simply not true. The terms of the agreements between Jewell Ridge and its mine operators have been considered by the Tax Court on two occasions in recent years. *Norman E. Clifton* Tax Court Docket No. 64659 decided April 21, 1958, Par. 58,065 P-H Memo T.C., and *Raymond E. Cooper*, et al, 39 T. C. 253 (1962). The court made no such finding in either case—indeed the contrary is true. In *Norman E. Clifton*, supra, the Tax Court found as follows:

"8. Jewell Ridge agreed to accept all coal produced by petitioner [contract mine operator] and there was no limitation on the amount of coal petitioner could produce."

The arguments of Jewell Ridge are the same as those made by the Commissioner and Paragon and respondents will not burden this brief with a repetitive discussion thereof.

CONCLUSION

On the basis of this Court's decision in *Parsons* v. *Smith*, supra, the court below concluded that the operators owned an economic interest in the mineral in place. This determination was based on the obligations of Paragon under its leases, which were assumed and performed by the operators, the continuing rights of the operators in the mineral deposit and the right to be paid for coal produced at a price closely related to the market price of coal. In these vital respects this case is clearly distinguishable from *Parsons* v. *Smith*, supra—indeed principles

of that case require an affirmance of the decisions of the court below.

Paragon placed the burden of development and production upon the operators, it agreed to pay only for marketable coal and it was the understanding between the parties that the income of the operators would be dependent upon the market price of coal. Under these circumstances, the depletion allowance is to be shared by the operators and Paragon because they were jointly interested in the development, production, processing and sale of the coal to be extracted. The decisions of the court below should be affirmed.

Respectfully submitted,

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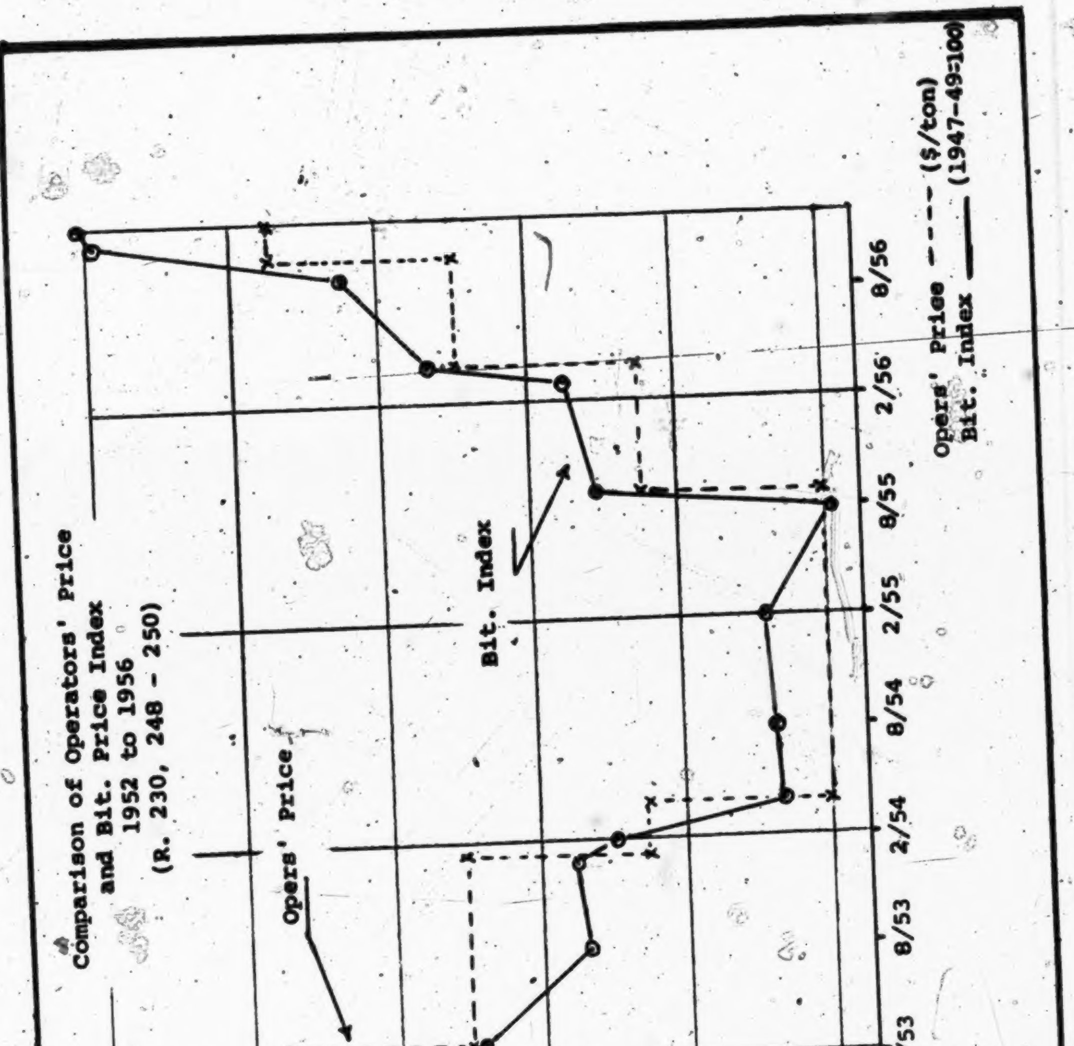
February, 1965

APPENDIX



Comparison of Operators' Price
and Bit. Price Index
1952 to 1956
(R. 230, 248 - 250)
Opers' Price
Bit. Index
Price
120
115
4.75
110
4.50
105
4.25
100
4.00
2/52
8/52
2/53
8/53
2/54
8/54
2/55
8/55
2/56
8/56
Opers' Price ---- ($/ton)
Bit. Index —— (1947-49=100)